

The Economic and Budget Outlook: An Update

September 1981

**A Report to the
Senate and House
Committees on the Budget**

As Required by Public Law 93-344

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CONGRESS OF THE UNITED STATES



CONGRESSIONAL BUDGET OFFICE

**THE ECONOMIC AND BUDGET OUTLOOK:
AN UPDATE**

**The Congress of the United States
Congressional Budget Office**

PREFACE

The Economic and Budget Outlook: An Update is one of a series of reports on the state of the economy issued periodically by the Congressional Budget Office. In accordance with CBO's mandate to provide objective analysis, the report contains no recommendations. The report was prepared by George R. Iden, Joan D. Schneider, Frank S. Russek, Jr., Stephen H. Zeller, Robert A. Dennis, Peter M. Taylor, Christopher D. Kask, Marvin M. Phaup, Jr., Joseph A. Ritter, John W. Straka, David M. Santucci, and Naif A. Khouri, under the direction of William J. Beeman and Lloyd C. Atkinson. Chapter IV was prepared by CBO's Budget Analysis Division under the direction of James L. Blum with the assistance of Rosemary Marcuss of the Tax Analysis Division. Robert L. Faherty and Francis S. Pierce edited the manuscript. Debra M. Blagburn, Dorothy J. Kornegay, and Marsha L. Mottesheard typed the many drafts. Art Services, Inc., prepared the graphic figures.

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September 1981

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The updated economic forecast of the Congressional Budget Office (CBO) shows substantial improvement in the economy compared with the lackluster performance of recent years. The slowing of inflation that began in the first half of 1981 is projected to continue into 1982. Real growth is expected to pick up late in 1981 and to be strong in 1982. The major reasons for the projected improvement in economic growth are the moderation of inflation and the reduction in taxes contained in the Economic Recovery Tax Act of 1981.

This forecast of strong real growth and moderating inflation depends critically on two highly uncertain factors. First, the economic projections assume that there will be no upsurge in commodity prices, such as the shocks in food and fuel prices that contributed to the economy's poor performance in the last several years. Second, money growth, consistent with Federal Reserve targets, could prove to be incompatible with strong economic growth.

Even with the projected improvement in the economy, CBO anticipates a budget deficit of about \$65 billion in fiscal year 1982, declining gradually to about \$50 billion in fiscal year 1984. These projections assume the spending policies of the First Concurrent Resolution on the Budget for 1982, which include still-unspecified spending cuts in 1983 and 1984. The CBO projections thus indicate that sizable spending cuts or revenue increases beyond those contemplated in the first resolution would be needed to achieve the target of a balanced budget in 1984.

The CBO Economic Forecast

Economic activity has been sluggish recently and is expected to show little or no improvement until the end of 1981. Correspondingly, for the remainder of the year, the unemployment rate is likely to remain near the 7 to 7-1/2 percent range experienced since the beginning of the year. Although inflation, as measured by the Consumer Price Index (CPI), may worsen a bit for a while before it gets better, by year's end a reduced pace of inflation

should be in evidence. Interest rates are also expected to begin moving downward later in the year in response to the improved inflation picture.

The CBO economic forecast for 1982 indicates that real growth will be strong, compared with that in 1981 and in the last several years. Inflation is expected to continue to decelerate. From the fourth quarter of 1981 to the fourth quarter of 1982, real gross national product (GNP) is forecast to increase by about 4 percent, while inflation, as measured by the GNP implicit price deflator, is projected to moderate to a rate of about 7 percent. Interest rates, although lower than in 1981, should remain high in 1982 because of reduced money growth and strong credit demands. The unemployment rate is also expected to turn down in 1982 (see Table 1).

TABLE 1. THE CBO FORECAST

Economic Variable	Actual	Projected	
	1979:4 to 1980:4	1980:4 to 1981:4	1981:4 to 1982:4
Nominal GNP (percent change)	9.4	9.2 to 13.4	9.3 to 13.5
Real GNP (percent change)	-0.3	1.5 to 3.5	3.1 to 5.1
GNP Implicit Price Deflator (percent change)	9.8	7.6 to 9.6	6.0 to 8.0
Unemployment Rate (percent, fourth quarter)	7.5	7.1 to 8.1	6.6 to 7.6
3-Month Treasury Bill Rate (percent, calendar-year average)	11.6	13.5 to 15.5	11.4 to 13.4

The strong growth projected for 1982 is a consequence of the slowed pace of inflation and the tax cut. The moderation of inflation is expected to reduce prices faster than wages thereby

stimulating real income growth, which in turn will lead to stronger demands. At the same time, with less inflation, the assumed monetary policy will accommodate more real growth.

In the years beyond 1982, CBO assumes that inflation will continue to decelerate; real growth will remain relatively strong; interest rates will continue their downward trek; and the unemployment rate will decline somewhat. In brief, the CBO economic assumptions for the period 1982-1984 contrast sharply with the unfavorable economic developments of the past several years.

The basic outlook for economic activity--slow growth for the remainder of 1981 with improvement in 1982--has not changed since CBO's forecast of last winter. The actual pattern of real growth for the first half of 1981 was close to that anticipated by CBO's winter forecast: The very strong performance in the early months of the year was followed by substantial weakening in the spring. The projected slowness of growth for the remainder of 1981 has not changed significantly, largely because interest rates have remained high--even somewhat higher than in the CBO winter forecast.

On the other hand, inflation has moderated more than projected earlier. This has improved the outlook for economic activity as well as for inflation since CBO's winter forecast. The principal reasons for the improved inflation rate during the first half of 1981 were the very favorable price developments in the food and energy sectors and a higher value of the U.S. dollar on the world's currency exchanges. These favorable price "breaks" were not foreseen by forecasters six months ago. The CBO forecast of continued improvement in inflation is based on the assumption of no adverse movements either in world commodity prices or in the dollar exchange rate over the near term. Moreover, the reduced inflation momentum is expected to slow wage inflation and reduce interest rates, outcomes that make room for higher real growth and reduced unemployment rates.

Recognizing the critical importance of commodity prices in the CBO forecast highlights the elements of uncertainty involved in it. Food and energy prices, and the foreign exchange value of the dollar, have historically been volatile. Thus, if poor weather, unrest in the Middle East, or other uncontrollable factors should once again cause sharply increased food or energy prices, the economic outlook would be much less optimistic. On the other hand, a decline in energy prices would have a favorable impact on the economy.

Another area of uncertainty concerns the relationship between economic activity and money growth. Some analysts, apparently including the Federal Reserve, argue that the Federal Reserve's targets for money growth are not consistent with strong economic growth, given the rates of inflation projected by most forecasters. The CBO forecast may be optimistic on this issue, but--given the projection of a decline in inflation and prospective changes in financial regulations and institutions--not overly optimistic.

The Budget Outlook

The First Concurrent Resolution on the Budget for Fiscal Year 1982 assumed large tax cuts, sharply reduced growth in federal spending, and a reallocation of resources from nondefense to defense spending. The enactment of both the Omnibus Budget Reconciliation Act and the Tax Act of 1981 went a long way toward achieving the goals of the first resolution, though additional spending cuts will be required to achieve the deficit targets. Implicit in the first concurrent resolution targets are additional savings--over those in the Reconciliation Act--of about \$15 billion in 1982, about \$35 billion in 1983, and about \$50 billion in 1984. (These figures include unspecified spending reductions of \$20 billion in 1983 and \$28 billion in 1984.) Even with these spending cuts, which are included in the CBO spending estimates, CBO anticipates a fiscal year 1982 budget deficit of about \$65 billion (see Table 2). The deficit is projected to decline gradually thereafter to around \$50 billion in fiscal year 1984. Nevertheless, if the spending cuts are realized, the deficit would be greatly reduced relative to GNP--from nearly 2 percent of GNP in fiscal year 1982 to about 1 percent in 1984, according to CBO's projections.

Comparison of CBO and Administration Economic and Budget Forecasts

Although the CBO forecast suggests that the economy's performance will improve sharply in 1982, CBO is not as optimistic as the Administration. In its Mid-Session Review, the Administration suggests that real growth through 1984 will be more rapid than CBO's projected increase, and that the unemployment rate will be slightly lower. Although the Consumer Price Index shows less inflation in the Administration's projections than in CBO's projections, the inflation projections are quite similar, when measured by the GNP implicit price deflator. Interest rates, on the other

TABLE 2. CBO AND ADMINISTRATION ECONOMIC AND BUDGET OUTLOOKS, 1981-1984

	1981	1982	1983	1984
<u>Economic Projections</u> (calendar years, in percent)				
Real GNP Growth				
Administration	2.6	3.4	5.0	4.5
CBO <u>a/</u>	2.3	3.1	4.1	4.0
GNP Implicit Price Deflator				
Administration	9.6	8.0	7.0	6.0
CBO <u>a/</u>	9.1	7.7	7.0	6.6
Unemployment Rate				
Administration	7.5	7.3	6.6	6.2
CBO <u>a/</u>	7.4	7.3	6.9	6.5
3-Month Treasury Bill Rate				
Administration <u>b/</u>	13.6	10.5	7.5	6.8
CBO <u>a/</u>	14.5	12.4	11.4	10.1
<u>Budget Projections</u> (fiscal years, unified budget basis, in billions of dollars)				
Revenues				
Administration	605.6	662.4	705.8	759.0
CBO <u>c/</u>	605	655	698	748
Outlays				
Administration	661.2	704.8	728.7	758.5
CBO <u>c/</u>	665	720	753	798
Surplus (+) or Deficit (-)				
Administration	-55.6	-42.5	-22.9	+0.5
CBO <u>c/</u>	-60	-65	-55	-50

SOURCES: Mid-Session Review of the 1982 Budget, July 15, 1981; Congressional Budget Office.

a/ The economic projections for 1981 and 1982 are the midpoints of the economic forecast ranges. The projections for 1983 and 1984 are not forecasts; they are assumptions.

b/ According to the Administration's Mid-Session Review, page 69, "These projections assume, by convention, that interest rates are linked to the rate of inflation. They are not forecasts of interest rates."

c/ Midpoints of CBO projection ranges. Assumes the spending policies of the First Concurrent Resolution on the Budget for Fiscal Year 1982, with the tax estimate adjusted to reflect the provisions of the Economic Recovery Tax Act of 1981.

hand, are substantially lower in the Administration projection. Table 2 highlights the differences between the CBO and Administration economic and budget projections. The differences in the budget estimates are largely on the spending side. In 1984, for example, higher outlays account for about 80 percent of the \$50 billion difference in forecasts of the deficit.

Conclusion

The CBO economic and budget forecasts, which are less optimistic than those of the Administration, depend heavily on a number of highly uncertain developments. The economic projections contain favorable assumptions about food and fuel prices and about the response of the economy to reduced money growth. In addition, the budget projections incorporate large spending cuts not yet specified or enacted. With respect to economic activity, the downside risks now seem to be substantial. Under an alternative set of less favorable, but not unreasonable, economic and spending assumptions, the federal budget deficit in 1984 could exceed \$50 billion by a considerable margin.

The economic impact of large deficits continuing through 1984 cannot be precisely estimated. On the one hand, if large deficits arise from a failure to achieve the spending cuts during a period of strong demands, the budget could become quite expansionary and thus contribute to inflation. If, on the other hand, they occurred because of weaker growth in demand, the enlarged deficit would not contribute significantly to inflationary pressures. Fiscal measures can also have favorable effects on productivity, which would reduce the adverse effects of deficits. Nevertheless, continued large deficits would imply higher interest rates than otherwise, which in turn would tend to deter investment and thereby reduce long-run growth.

CHAPTER II. RECENT ECONOMIC DEVELOPMENTS

The U.S. economy turned in a roller-coaster performance during the first half of 1981. The opening quarter saw real GNP rise at an 8.6 percent annual rate, followed in the second quarter by a 2.4 percent decline. The negative second quarter has caused some speculation that the economy may have moved into yet another recession; but this is not supported by evidence of major imbalances in the economy, such as excessive inventories or overbuilding of structures, that would lead one to project a prolonged decline in real economic activity. Indeed, there appear to be considerable pent-up demands for housing and other durable goods that could be released if financial conditions improve substantially. There is risk, of course, that continuation of present financial conditions could cause more sluggish growth than is now forecast by CBO. Barring such adverse developments, a deep recession in the near term is unlikely.

GNP GROWTH

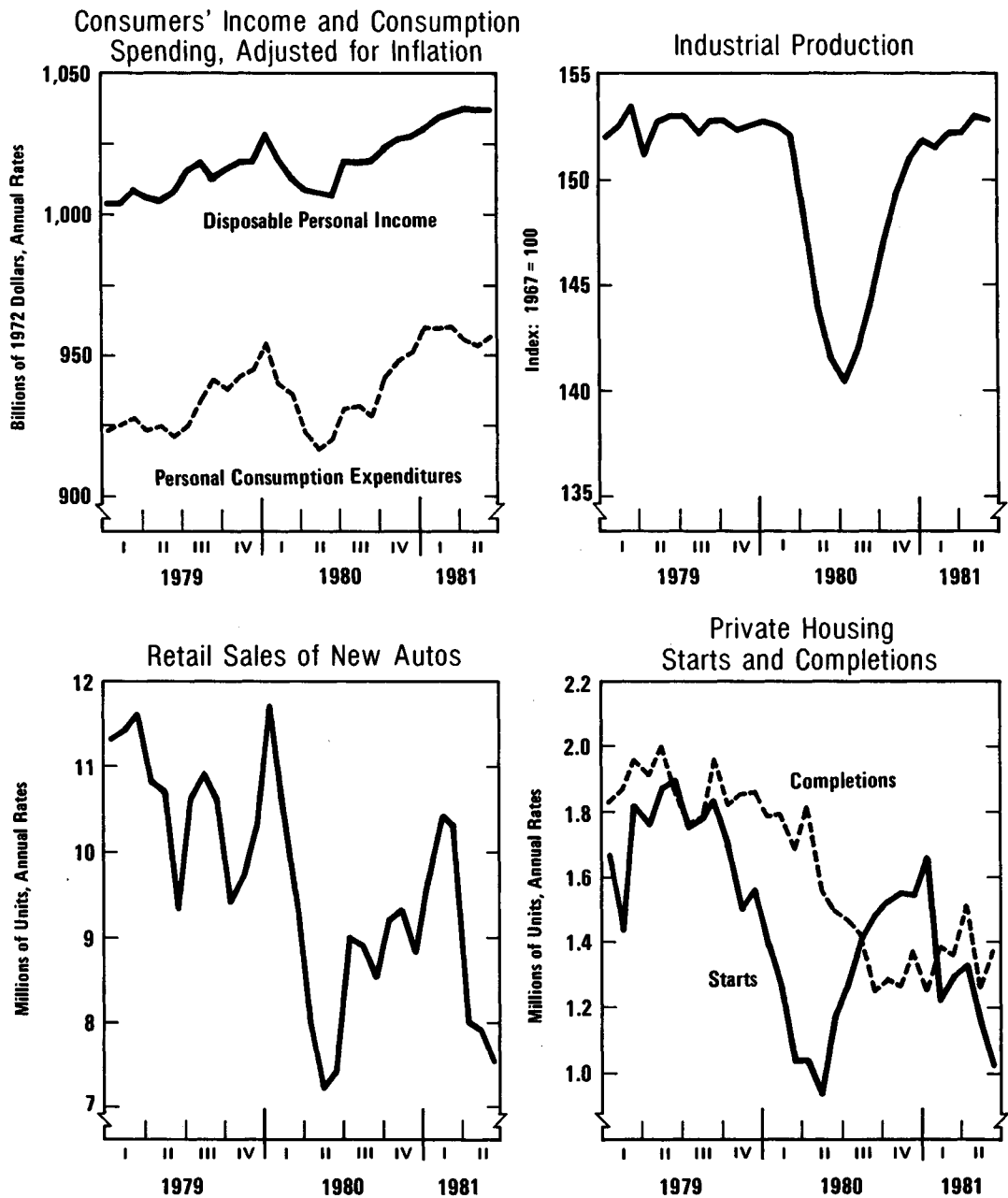
Viewed in isolation, the inordinately large increase in real GNP in the first quarter and the negative growth in the second provide a distorted picture of the economy for the first half of 1981. A more accurate picture is this: Recovery from the very sharp drop in economic activity in the first half of 1980 continued at a robust pace through the fourth quarter of 1980 and into the first month or so of 1981, but slowed appreciably thereafter; since January, the economy has essentially been moving sideways at a level close to the peak value it attained at the beginning of 1980. Monthly data for real personal consumption expenditures and industrial production, displayed in Figure 1, tend to confirm this view.

The peculiar patterns of change of GNP and its components for the first half of 1981, documented in Table 3, can be partly explained by various "special" economic and statistical factors.

- o The 8.6 percent rate of growth of real GNP registered for the first quarter of this year overstates the growth that actually occurred during that quarter. Although economic growth during much of the first quarter was negligible, the

Figure 1.

Selected Indicators of Economic Activity



SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census; Federal Reserve System, Board of Governors.

TABLE 3. INDICATORS OF ECONOMIC ACTIVITY (Percent change from previous quarter at seasonally adjusted annual rate, unless noted)

	1980:1	1980:2	1980:3	1980:4	1981:1	1981:2
Real GNP	3.1	-9.9	2.4	3.8	8.6	-2.4
Final sales	3.1	-10.4	4.1	4.4	6.9	-5.2
Personal consumption expenditures	0.8	-9.8	5.1	7.0	5.8	-2.0
Durable goods	-1.6	-43.3	21.7	21.2	24.1	-23.6
Motor vehicles and parts	12.5	-67.2	44.2	26.3	51.7	-47.8
Nondurable goods	0.2	-5.3	-1.8	6.3	4.6	2.4
Services	2.1	0.0	6.4	3.7	1.4	2.3
Fixed investment	-5.3	-31.8	2.1	15.7	10.8	-8.3
Nonresidential	2.2	-19.9	-1.5	4.0	13.3	-4.0
Structures	-1.4	-13.1	-15.3	9.0	16.6	5.1
Producers' durable equipment	3.8	-22.7	5.3	1.9	11.8	-7.8
Autos	50.8	-59.5	90.3	16.9	56.0	-41.7
Residential	-24.2	-60.2	16.0	64.2	3.6	-21.0
Government Purchases	6.9	2.5	-5.0	2.2	5.4	-5.8
Federal	18.9	11.9	-13.1	2.0	14.8	-9.0
Defense	9.8	6.2	-0.1	5.9	1.1	2.0
Nondefense	38.4	23.1	-33.1	-5.3	46.8	-27.0
State and local	0.6	-2.8	0.3	2.3	0.2	-3.8
Exports	32.0	12.3	-0.2	-7.4	13.6	-6.9
Imports	11.9	-21.9	-20.4	25.8	10.3	12.9
Change in business inventories (billions of 1972 dollars)	-0.9	1.3	-5.0	-7.2	-1.4	9.7
Real Disposable Personal Income	1.3	-4.9	4.1	2.9	3.0	1.2
Saving Rate (percent)	4.9	6.2	6.1	5.1	4.6	5.3
Industrial Production	-0.1	-19.2	-6.7	21.2	7.4	2.4
Labor Force	1.8	1.8	1.1	0.7	2.4	3.7
Unemployment Rate (percent)	6.2	7.3	7.5	7.5	7.3	7.4

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Federal Reserve System, Board of Governors; and U.S. Department of Labor, Bureau of Labor Statistics.

fact that production rose rapidly all through the fourth quarter of 1980 meant that the average level of GNP for the first quarter of 1981 was statistically much higher than the average GNP level for the fourth quarter of 1980, yielding a high rate of growth measured quarter over quarter.

- o Because consumers and businesses took advantage of the sizable auto rebates that were offered mainly in February and March, consumer durable expenditures and business fixed investment in the first quarter of 1981 rose much more rapidly than would have occurred otherwise; consumer and business spending retrenched in the second quarter when the auto rebate programs were terminated. These volatile swings in real consumer and business spending for autos had negligible effects on real GNP growth in the first half of 1981 since they were largely mirrored by offsetting movements of auto stocks, the rundown of auto stocks in the first quarter being followed by an upsurge in the second. Auto production was little changed over first two quarters.
- o The sharp swing in real federal government spending--up 14.8 percent in the first quarter of 1981 and down 9.0 percent in the second quarter (at annual rates)--is explained almost exclusively by peculiarities in the timing of loan commitments and loan redemptions by the Commodity Credit Corporation (CCC). Total real federal purchases less CCC outlays were virtually unchanged over the first half of 1981.
- o The vigorous uptick in nonresidential construction and the more modest increase in residential investment in the first quarter of 1981 were largely the result of unseasonably warm weather.
- o The increase in real non-auto business inventories contributed to growth in the early months of 1981. Its impact, however, was masked by the dramatic swings in new auto stocks--down \$6.2 billion in the first quarter and up \$7.3 billion in the second quarter, after adjustment for inflation.

Other statistics support the view that the economy has followed a flat trajectory since the early months of 1981. The rapid pace of real expenditures for furniture and appliances in the

first quarter turned negative in the second quarter; the double-digit rate of real growth for apparel reported in the first quarter was halved in the second quarter; and the essentially flat level of real purchases by state and local governments in the first quarter was followed by negative growth in the second quarter. This pattern of essentially no growth in the economy is expected to continue in the third quarter.

Reflecting the sluggish growth of the economy, the unemployment rate changed little over the course of the first eight months of 1981, hovering in the 7 to 7-1/2 percent range throughout. CBO expects the unemployment rate to increase modestly in the remainder of the year.

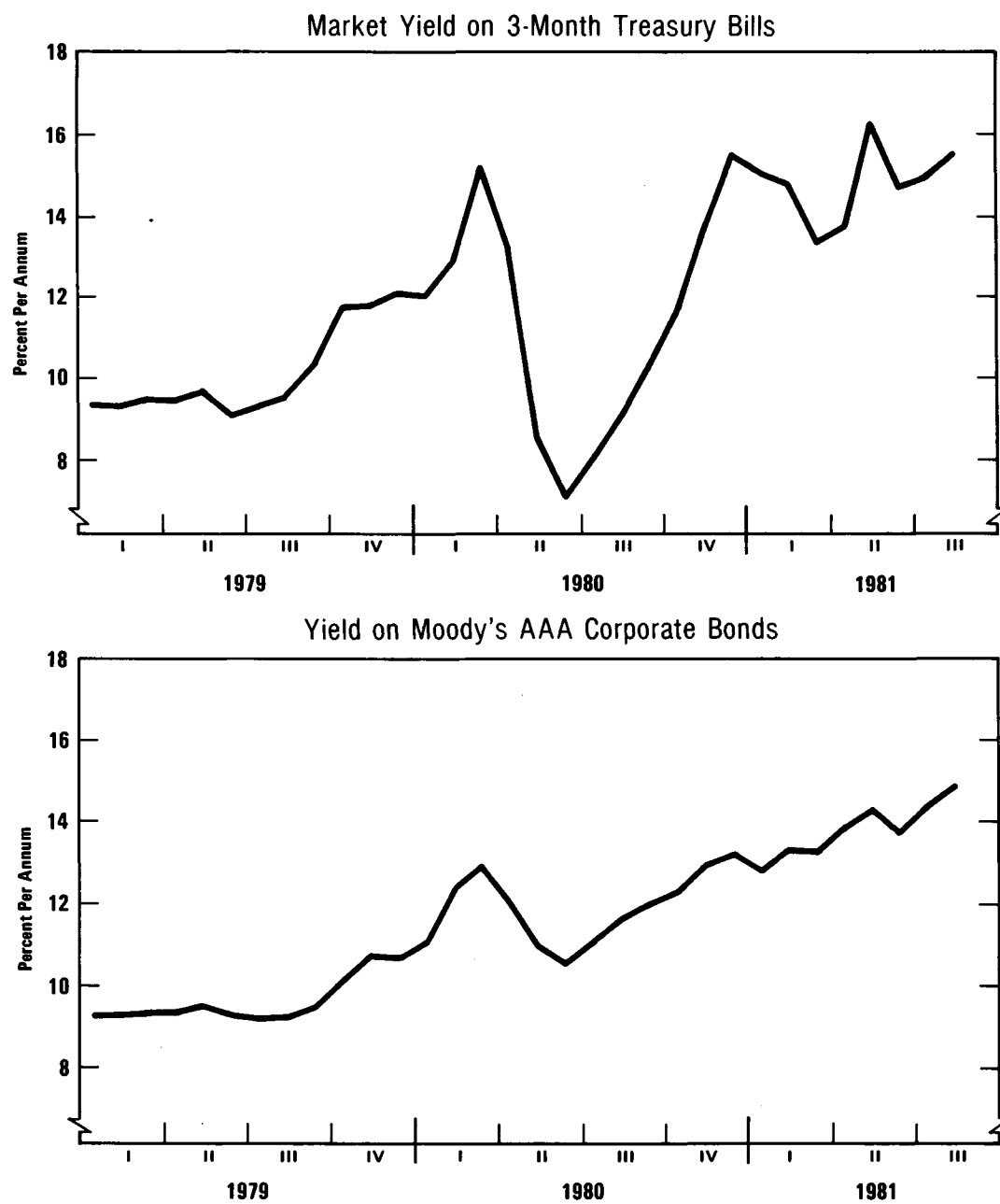
The sluggish performance of the economy in the spring and summer of 1981 should occasion little surprise in view of the record high interest rates and the increasing restrictiveness of fiscal policy; what is surprising, perhaps, is that economic activity continued at a fairly high level despite the monetary and fiscal policies then in place. By most measures, fiscal policy turned restrictive in the first half of 1981, mainly because of the large increase in Social Security taxes in January and the increase in the windfall profits tax resulting from the decontrol of domestic oil prices. But the dominant policy story in the first eight months of 1981 concerns the record high interest rates that contributed to the extreme weakness in both housing and auto sales, highlighted in Figure 2.

INTEREST RATES

The year began with short-term interest rates at or near record highs. They eased somewhat over the course of the first quarter, but resumed their uptrend early in the second; in early September, they were at or above the levels recorded at the beginning of the year. The pattern of change in the three-month Treasury bill rate, displayed in Figure 2, is typical. Many economists do not find this behavior of short-term interest rates surprising in view of the Federal Reserve's policies.

Long-term interest rates continued their upward advance through May. They eased somewhat in June but turned up again in July and continued upward through August. The continued upward movement of long-term interest rates is not easily understood in

Figure 2.
Interest Rates



SOURCES: Federal Reserve System, Board of Governors; Moody's Investors Services, Inc.

view of the moderated pace of inflation. Apparently inflationary expectations have not been dampened significantly.

- o The favorable developments in inflation have occurred in markets (food and energy) in which inflationary expectations may not figure prominently in the determination of the rate of price change.
- o The moderation of price inflation has yet to show up in a corresponding reduction in wage inflation, as will be noted below.
- o Belief in the Federal Reserve's ability to control the monetary aggregates may have been undermined, especially as a result of the volatile behavior of the money supply and interest rates during 1980.
- o A great deal of emphasis is being placed on expected heavy borrowing by the federal government in credit markets. Although the reduction in the federal deficit is a goal much emphasized by the Administration and the Congress, financial markets may be somewhat skeptical that it can be achieved.

CBO expects that both short-term and long-term interest rates will soon begin to fall. With the economy continuing its lack-luster performance in the months ahead and inflation improving, CBO's assumption that the growth of the monetary aggregates will be within the Federal Reserve's target ranges should be consistent with a modest decline in short-term interest rates. Between calendar years 1981 and 1982, short-term interest rates decline about two percentage points in the CBO forecast. Long-term interest rates are also expected to decline gradually in response to reduced inflation.

INFLATION

The good news in the first half of the year was the marked slowing of inflation. After advancing at a seasonally adjusted annual rate of nearly 13 percent in the fourth quarter of 1980, the growth of the Consumer Price Index (CPI) slowed in the first quarter to an annual rate of 10.8 percent, and further still in the second quarter to an annual rate of 7.5 percent. As Table 4 makes clear, the GNP implicit price deflator, the GNP fixed-weighted

TABLE 4. PRICE INFLATION (Percent change, seasonally adjusted annual rate)

	1980:1	1980:2	1980:3	1980:4	1981:1	1981:2
CPI-U <u>a/</u>	16.5	13.1	7.7	12.9	10.8	7.5
CPI-U less Food and Energy	14.8	13.9	6.9	13.2	8.9	8.9
Producer Price Index for Finished Goods	16.5	10.5	14.0	8.9	10.7	8.3
GNP Implicit Price Deflator	9.3	9.8	9.2	10.7	9.8	6.6
GNP Fixed-Weighted Price Index	9.7	9.3	9.0	10.4	10.2	8.0

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics;
U.S. Department of Commerce, Bureau of Economic Analysis.

a/ Consumer Price Index for all urban consumers.

price index, and the Producer Price Index (PPI) for finished goods showed the same kind of inflation moderation. The July increase in the CPI, 15.2 percent at an annual rate, contrasts sharply with these favorable trends, but the CBO forecast suggests that this rise represents only a temporary departure that may last only a month or two.

Why did inflation moderate so dramatically? Simply put, because of very favorable price developments in the food and energy sectors and the marked appreciation of the dollar in foreign exchange markets. In its January 1981 report, the Council of Economic Advisers anticipated a sharp acceleration in food prices during 1981--from 8.6 percent in 1980 to about 12 percent in 1981--principally because of the poor feed-grain harvests of 1980. The increased grain prices were expected in turn to cause reduced levels of meat production and dramatically higher meat prices. As it turned out, many cattle ranchers decided last winter to bypass

feedlots and send some cattle directly to slaughter. This temporarily made more beef available for market and delayed until mid-1981 the expected increase in beef prices. At the same time, sugar prices in international markets fell rapidly from their peak values of last fall. Neither of these favorable movements in food prices is likely to be repeated in the second half of 1981: The reduction in beef supplies is now showing up in the form of higher wholesale and retail meat prices, and sugar prices at the wholesale level are not expected to fall any further because they are at or near their international support levels.

Largely as a result of the expected increase in retail meat prices, average food prices in 1981 should rise to a level about 8-1/2 percent higher than in 1980. For 1982, the prospects for moderation in food price increases are good because world grain harvests for the 1981 crop year are expected to be much better than those in 1980. Nevertheless, in the medium term, food prices are likely to continue to increase faster than other prices because world food demand is pressing upon agricultural capacity. The CBO forecast implies that food prices will rise about 1 percent faster than other prices in 1982.

Oil prices, too, have been falling in international markets for the past few months--a development that was not expected last winter. The emergence of an oil supply glut can be attributed to three factors:

- o Slow economic growth in consuming countries;
- o A relatively large drop in demand in response to last December's oil price increases, which was helped along in the United States by the decontrol of domestic oil prices, and in other countries by the sharp appreciation of the dollar that caused the foreign currency price of oil to rise despite a decline in its dollar price; and
- o High oil production by Saudi Arabia and other oil-producing countries.

The softness in oil prices is expected to continue for perhaps a year. The abatement of upward price pressure is evident in the widely publicized price cuts by the United Kingdom and several OPEC producers following the August OPEC meeting. What happens to oil prices, however, will depend greatly on the production policies of Saudi Arabia and other OPEC countries.

The price path chosen for the CBO forecast assumes a resumption of world oil price increases in the second half of 1982, running at about 8 percent (slightly above the rate required to keep oil prices constant in real terms). The experience of recent years suggests that this forecast is subject to much uncertainty. A variety of circumstances, ranging from renewed unrest in the Middle East to earthquakes to violent storms in the North Sea, could disrupt oil supplies enough to push prices up much faster. A resumption in demand growth in the industrialized countries could also increase oil prices. ^{1/} On the other hand, a lower oil price path is also possible if there is sluggish economic growth in the developed countries, or if Iran and Iraq resume high rates of production and other OPEC countries do not reduce production correspondingly.

Finally, some moderation of inflationary pressures has occurred as a consequence of the marked appreciation of the U.S. dollar internationally--up over 23 percent on a trade-weighted basis between December 1980 and August 1981. Sluggish U.S. economic growth, historically high U.S. interest rates, and lower U.S. inflation generally have all served to raise the foreign exchange value of the dollar. For the remainder of 1981 and 1982, the dollar is expected to remain fairly stable--in part because no significant changes in inflation and real growth differentials are expected between the United States and its trading partners, and in part because U.S. interest rates are expected to remain relatively high.

WAGE DEVELOPMENTS

The deceleration of inflation in the first half of 1981 has not yet been clearly matched by a reduction in the pace of wage advance. Indeed, trends in labor costs showed only slight moderation over the course of the first half of the year, which means that underlying inflationary pressures remained strong (see Table 5). Measured in terms of percentage change from one year earlier, the Index of Average Hourly Compensation--which includes

^{1/} Recent forecasts by the Organization for Economic Cooperation and Development (OECD) and the International Monetary Fund (IMF) suggest that demand growth outside the United States will be very limited in the next few years.

TABLE 5. LABOR COSTS (Seasonally adjusted annual rate)

	1980:1	1980:2	1980:3	1980:4	1981:1	1981:2
	Percent Change from <u>One Year Earlier</u>					
Compensation per Hour <u>a/</u>	9.7	9.9	10.1	10.1	10.4	10.0
Employment Cost Index <u>a/</u> <u>b/</u>	9.1	9.3	9.4	9.0	9.3	9.3
	Percent Change from <u>Previous Quarter</u>					
Average Hourly Earnings Index	9.1	10.0	9.1	10.4	9.7	8.3
Unit Labor Costs <u>a/</u>	9.9	14.6	5.3	10.1	7.0	8.8

SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

a/ Data are for the private nonfarm economy.

b/ Index for wage and salary component of compensation.

both employer contributions to social insurance and the costs of fringe benefits--rose at double-digit rates in the first and second quarters of 1981, little changed from the rate of advance in 1980. The Employment Cost Index for wages and salaries confirms the sustained high level of wage inflation observed in the compensation data: Measured in terms of percentage change from one year earlier, the Employment Cost Index has shown little change in the past 18 months. Although both of these measures showed a moderation in wage gains in the second quarter of 1981, following sharp